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No. 07-961

In The
Supreme Court of the United States

CENTERIOR ENERGY CORPORATION, ET AL.,
Petitioners,

v.

JEROME R. MIKULSKI, ET AL.,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

REPLY BRIEF FOR THE PETITIONERS

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REPLY BRIEF FOR THE PETITIONERS

Nothing in respondents' brief changes the pervasively federal character of their "state law" claims. At bottom, their claims turn critically on allegations that petitioners misread federal tax law in calculating their federally defined corporate "earnings and profits," causing petitioners to misreport federal tax data, under pain of federal penalties, to a federal agency on a federally mandated form, resulting (allegedly) in respondents' overpayment of their federal taxes to the federal government. Respondents' arguments that the law permits their case to proceed in state court simply highlight the confusion plaguing the lower courts as they try to apply this Court's decisions. This Court should grant certiorari to resolve the conflict in circuit law. In the alternative, the judgment should be vacated and the case remanded for further consideration in light of the Court's decision this week in *United States v. Clintwood Elkhorn Mining Co.*, No. 07-308 (Apr. 15, 2008), holding that the federal tax refund scheme provides the exclusive mechanism for seeking relief for federal tax overpayments.

1. Respondents offer no sound distinction between this case and the Court's unanimous holding in *Grable & Sons Metal Prods., Inc. v. Darue Eng'g & Mfg.*, 545 U.S. 308, 310 (2005), that a state-law quiet title action "arises under" federal law when the plaintiff's claim turns on a "disputed issue of federal title law." In so holding, the Court stressed "the national interest in providing a federal forum for federal tax litigation."

Respondents repeatedly argue (BIO 1, 10, 15) that Section 312(n) is "an obscure provision of the federal tax code." Perhaps, but respondents' allegations depend on much more than that one tax code section:

(i) Petitioners' reports rested on their interpretation of 26 U.S.C 312(n), which determines the federal tax treatment of more than $1 billion in construction expenses.

(ii) Petitioners' reports were compelled by 26 U.S.C. 6042(a)(1) – which requires the company to file an "informational return" reporting dividends and returns of capital to the IRS, subject to penalties for noncompliance under 26 U.S.C. 6721(a) and (e) and 26 U.S.C. 7203 – as well as 26 U.S.C. 6042(c), which requires the company to report that same information to shareholders.

(iii) Respondents' alleged damages stem from 26 U.S.C. 316(a), which deems shareholder distributions up to the amount of its earnings and profits (as defined by 26 U.S.C. 312) to be "dividends"; 26 U.S.C. 301(c)(1), which generally requires shareholders to treat dividends as ordinary income; 26 U.S.C. 1(a)-(e), which specifies the tax rate for ordinary income; 26 U.S.C. 301(c)(2)-(3), which provides that returns of capital in excess of the shareholders' adjusted basis in stock are treated as capital gains; and 26 U.S.C. 1(h), which specifies the tax rate for capital gains.[1]

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[1] The two non-federal sources of law and duties that respondents identify are entirely derivative of and determined by federal tax law. Thus, respondents' assertion that "Centerior violated its shareholder agreements" is premised on the claim that petitioners violated "§ 6042(c) by providing inaccurate Forms [*sic*] 1099-DIV to shareholders." BIO 5. And any allegedly

Beyond that, there is nothing obscure about the court of appeals' en banc decision, which applies equally to numerous other Internal Revenue Code provisions that are individually rarely litigated but that, together with Section 312(n), define a taxpayer's earnings and profits. The court of appeals' decision now licenses the many millions of recipients of federal 1099 forms to evade the federal tax refund process, the applicable statute of limitations, and the federal court system simply by training their sights on the IRS's conscripted reporting agents.[2]

In any event, whether a claim "arises under" federal law turns upon the substantive role that federal law plays in the lawsuit, not the frequency with which the particular tax provision is otherwise litigated. *Grable* held that the disputed federal tax law question arose under federal law because the issue

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overpaid state taxes that would be included in respondents' damages (*id.*) would depend directly and exclusively on those States' adoption of the federal definition of taxable dividends. See, *e.g.*, Cal. Rev. & Tax Code §§ 17071, 17072, 17073; O.R.C. § 5747.01(A).

[2] See 26 U.S.C. 312; 26 C.F.R. 1.312-6(b), 167(f), 168, 179, 302(a), 311(b), 381(c), 356, 460, 1502 (all rules applicable in the calculation of "earnings & profits"); Rev. Rul. 75-515, 1975-2 C.B. 117; Boris Bittker & James Eustice, Federal Income Taxation of Corporations and Shareholders (7th ed. 2005) ¶ 8.03[3] (explaining that, "[t]o compute [a] corporation's earnings and profits is often no simple task," and noting that, in undertaking such a calculation, "Certain Items Excluded from Taxable Income Must Be Included," "Certain Items Deducted in Computing Taxable Income May Not Be Deducted," and "Certain Items Not Deducted in Computing Taxable Income May Be Deducted in Computing E&P"; calculation also includes "Timing Differences: Deferred Income and Accelerated Deductions," "Corporate Distributions and Changes in Capital Structure").

was central to the plaintiff's claim and, by its very nature as a tax issue – not its popularity – would benefit substantially from the expertise and consistency provided by a federal forum. 545 U.S. at 315.

Respondents' further argument that their state-law claims have additional state-law elements is no different than the quiet title claim in *Grable*. Like *Grable*, respondents have "certainly staked their claim on this federal issue" (Pet. App. 30a), and "concede that their claim will fail under [petitioners'] interpretation of [the Internal Revenue Code]" (*id.* at 31a).

Further, like *Grable*, "it will be the rare state [breach of contract] case that raises a contested matter of federal law" (545 U.S. at 315), so removal of respondents' claim "would not materially affect, or threaten to affect, the normal currents of litigation" (*id.* at 319). Respondents' only answer is to caricature petitioners' position as "categorically providing for federal jurisdiction for *every* state-law claim requiring interpretation of *any* provision of federal tax law." BIO 18. But petitioners' point is simpler and narrower: under *Grable*, a plaintiff cannot evade federal jurisdiction over a suit that rests critically and indispensably on a contested reading of the federal tax code by a party acting under the command of federal law and mandate of the IRS to serve federal revenue ends just by throwing "breach of contract" garb over the case.

Indeed, this is a substantially stronger case for "arising under" jurisdiction than *Grable*, because Congress has *specifically provided* in 26 U.S.C. 7434 "a federal right of action for the exact type of tax mis-

reporting alleged here." BIO 23; contrast *Grable*, 545 U.S. at 319 (distinguishing *Merrell Dow Pharms. v. Thompson*, 478 U.S. 804 (1986)).

Finally, respondents suggest that the question lacks "continuing importance" because a later case might hold that Section 7434 "completely preempts [a state law] claim." BIO 23. But the en banc Sixth Circuit already rejected precisely that argument, finding no "indication that Congress intended [that provision] to be the exclusive remedy for a fraudulent overstatement of taxable dividend distributions." Pet. App. 15a.

2. Respondents – like the Sixth Circuit – assert that certain factual distinctions drawn in *Empire HealthChoice Assurance, Inc. v. McVeigh*, 547 U.S. 677 (2006), substantially unravel *Grable*'s unanimous holding. See BIO 11-13; Pet. App. 31a-35a. But that argument – which other circuits do not embrace – simply highlights the need for this Court's clarification of "arising under" law. The Sixth Circuit's reading of two short paragraphs in *Empire* as articulating an entirely new standard for "arising under" jurisdiction misreads this Court's decision, which made those distinctions only to "explain why this case does not resemble [*Grable*]." 547 U.S. at 699.

Beyond that, *Empire*'s distinctions are of no help to respondents. The federal law questions here are just as "dispositive of the case" (547 U.S. at 700), and present just as "pure [an] issue of law" (*ibid.*) as the service-of-process provision in *Grable*. The direct involvement of a federal agency plainly is not a prerequisite to "arising under" jurisdiction. See, *e.g.*, *City of Chicago v. International College of Surgeons*, 522

U.S. 156, 164 (1997); *Hopkins v. Walker*, 244 U.S. 486, 488 (1917)). In any event, petitioners "did not choose the role of [reporting] agents" for the IRS. *Brennan v. Southwest Airlines Co.*, 134 F.3d 1405, 1411 (9th Cir. 1998) (quoting *DuPont Glore Forgan, Inc. v. AT&T Corp.*, 428 F. Supp. 1297, 1306 (S.D.N.Y. 1977), *aff'd*, 578 F.2d 1366 (2d Cir.), *cert. denied*, 439 U.S. 970 (1978)). They had it thrust upon them by federal tax law, on pain of criminal and civil liability. See 26 U.S.C. 6721(a) & (e), 6722, 7203; 26 C.F.R. 301.6721-1(a) & (f), 301.6722-1(a) & (c).

Finally, the need for this Court's review and resolution of conflicting rules of circuit law is reinforced by the Sixth Circuit's adoption of a multi-factor balancing test, which entails a series of "subjective" and "speculative" inquiries (Pet. App. 33a, 38a), culminating in the determination that a "significant" federal tax interest was not also "substantial" (*id.* at 37a), in part because of the court's "subjective view * * * that this particular question is not particularly important to the federal government" (*id.* at 33a). "[J]urisdictional rules should be clear." *Lapides v. Board of Regents*, 535 U.S. 613, 621 (2002).

3. Not surprisingly, no other circuit applies such a subjectively judgmental, multi-factor approach to "arising under" jurisdiction. The Second, Tenth, and Federal Circuits, now joined by the Fifth Circuit,[3]

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[3] See *Berhard v. Whitney Nat'l Bank*, No. 07-30464, 2008 U.S. App. LEXIS 7524 (5th Cir. Apr. 2, 2008) ("[A] case pleading only state law claims may arise under federal law 'where the vindication of a right under state law necessarily turn[s] on some construction of federal law. The federal courts have jurisdiction

have adopted bright-line legal tests that comport with this Court's precedent and that would recognize "arising under" jurisdiction in this case.

While respondents initially assert that the Federal Circuit's decisions consider "the facts of each case" (BIO 21), they ultimately acknowledge the "categorical[]" rule adopted by that court (*ibid.*). See *Immunocept, LLC v. Fulbright & Jaworski, LLP*, 504 F.3d 1281 (2007); *Air Measurement Techs. v. Akin Gump Strauss Hauer & Feld LLP*, 504 F.3d 1262 (2007). Importantly, the tort claims subject to federal jurisdiction under that court's *per se* approach neither rest on pure questions of law nor turn on the conduct of federal agencies. And the Federal Circuit has rejected respondents' proffered distinction between the general and patent-specific jurisdictional statutes: "[I]n *Christianson* [*v. Colt Indus. Operating Corp.*, 486 U.S. 800 (1988)], the Supreme Court grafted § 1331 precedent onto its § 1338 analysis and held that the phrase 'arising under' has the same meaning in § 1338 as it does in § 1331, the general federal-question provision." *Air Measurement*, 504 F.3d at 1271.

The Tenth Circuit in *Nicodemus v. Union Pac. Corp.*, 440 F.3d 1227 (2006), likewise articulated a legal standard that directly conflicts with the ruling below: "A case should be dismissed for want of a substantial federal question only when the federal issue

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over a state law claim that 'necessarily raise[s] a stated federal issue, actually disputed and substantial, which a federal forum may entertain without disturbing any congressionally approved balance of federal and state judicial responsibilities.") (quoting *Franchise Tax Bd. v. Construction Laborers Vacation Trust*, 463 U.S. 1, 9 (1983), and *Grable*, 545 U.S. at 314).

is '(1) wholly insubstantial or obviously frivolous, (2) foreclosed by prior cases which have settled the issue one way or another, or (3) so patently without merit as to require no meaningful consideration." *Id.* at 1236. Respondents' assertion that the government's reversionary interest in the property gave it "a direct interest in the outcome of the proceedings" (BIO 19), received only a passing mention in *Nicodemus* (*id.* at 1236), with no effect on the legal rule adopted and enforced.

Finally, respondents' argument that the Second Circuit's decision in *Broder v. Cablevision Sys. Corp.*, 418 F.3d 187, 195 (2005), involved a "complex federal regulatory scheme" (BIO 20) highlights the conflict arising from the Sixth Circuit's treatment of federal tax – and federal tax reporting – schemes, which are at least equally complex. Respondents' argument also ignores the head-on conflict created by the Second Circuit's rule that federal jurisdiction is proper if the "federal issues are not clearly insubstantial" (*Broder*, 418 F.3d at 195), a test that is readily satisfied here.[4]

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[4] "Arising under" jurisdiction was properly rejected by the district court rulings cited by respondents (BIO 22), all of which involved state claims that merely included a federal standard as one element. See generally *Grable*, 545 U.S. at 318-19 (distinguishing *Merrell Dow*); see also *Elmira Teachers' Ass'n v. Elmira City Sch. Dist.*, No. 05-CV-6513, 2006 U.S. Dist. LEXIS 3893, 17-18 (W.D.N.Y. 2006) ("This lawsuit, simply put, is a state breach of contract and negligence case in which [a federal provision] * * * merely provides the standard of care."); *Callahan v. Countrywide Home Loans, Inc.*, No. 3:06cv105/RV/MD, 2006 U.S. Dist. LEXIS 42860 (N.D. Fla. 2006) ("[The claim] is an ordinary state law negligence claim that uses the Defendant's failure to comply with [a federal provision] as a basis for

4. Respondents contend that their suit is not completely preempted by 26 U.S.C. 7422 because they do not allege that the tax was "erroneously or illegally assessed or collected," since "the IRS was an innocent third-party" that "merely relied on the 1099-DIVs issued by [petitioners]." BIO 25-26. But Section 7422 broadly reaches the attempted recovery of "any sum alleged to have been excessive" under the tax law. See *United States v. Clintwood Elkhorn Mining Co.*, No. 07-308, slip op. at 11 (Apr. 15, 2008); *Flora v. United States*, 362 U.S. 145, 149 (1960). There thus is no dispute that respondents "could have raised the issue with the Internal Revenue Service, could have filed for a refund, or could have pursued administrative remedies" (Pet. App. 54a), placing their claims squarely within the scope of Section 7422.

Furthermore, the refund scheme applies regardless of the cause of the alleged error. See 26 U.S.C. 6401(c) ("An amount paid as tax shall not be considered not to constitute an overpayment solely by reason of the fact that there was no tax liability in respect of which such amount was paid."); *United States v. Williams*, 514 U.S. 527 (1995) (tax refund scheme includes refund sought by a third party based on an assessment against another taxpayer). To read the language of Section 7422 as respondents propose would open up a yawning exception to the tax refund scheme, allowing taxpayers to circumvent the admin-

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the duty element of negligence."); *Caggiano v. Pfizer, Inc.*, 384 F. Supp. 2d 689, 691 (S.D.N.Y. 2005) ("[T]here is no federal question jurisdiction over garden-variety state-law claims 'resting on federal mislabeling and other statutory violations'").

istrative exhaustion, statute-of-limitations, and other remedial constraints on refund actions any time the taxpayer can assert that someone other than the IRS is to blame.

Respondents note (BIO 28) that petitioners did not actually collect the taxes themselves. But that is a distinction without a difference. Federal law requires companies to report tax information to the IRS, in a manner designated by the IRS and on terms imposed by the IRS, based on the calculation and utilization of federal tax rules to determine federally defined "earnings and profits," because such reporting is critical to the IRS's administration of the federal tax scheme. See, *e.g.*, IRS, *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* 20 (2007). In that respect, the corporation acts as the right hand of the IRS in the tax assessment process. See *Brennan*, 134 F.3d at 1411 ("In so collecting the tax * * *, the defendants act merely as agents for the United States."); *Sigmon v. Southwest Airlines Co.*, 110 F.3d 1200, 1203 (5th Cir. 1997), ("Southwest acts as the government's agent in collecting airline ticket excise taxes," and "Section 7422 protects from lawsuits private entities * * * that are required by statute to collect taxes for the government under threat of criminal penalty."); *Kaucky v. Southwest Airlines Co.*, 109 F.3d 349, 353 (7th Cir. 1997), ("[Section] 7422 is designed to confine suits for the refund of federal taxes to suits * * * against the government in order to protect its private [collection] agents from being whipsawed.").

Respondents contend that the federal tax refund scheme should allow exceptions based on the particu-

lar nature of the illegality alleged and the asserted inability of the federal tax refund scheme to resolve "categorical determination[s]." BIO 26-27. In *Clintwood Elkhorn*, however, the Court rejected the virtually identical arguments "[W]e cannot imagine what language could more clearly state that taxpayers seeking refunds of unlawfully assessed taxes must comply with the Code's refund scheme before bringing suit." Slip op. at 5. Accordingly, if the Court does not grant plenary review, the Court should vacate the judgment below and remand for reconsideration in light of *Clintwood Elkhorn*.[5]

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[5] Respondents contend that "remand of one of the four cases [underlying the petition] is required because petitioners' notice of removal in that case was untimely." BIO 29 n.10. The district court properly rejected that argument, recognizing that respondents disclosed their reliance on Code Section 312(n) – triggering the time limit on removal in the case – only after the court had "directed the plaintiffs to clarify" their claim. Pet. App. 51a.

CONCLUSION

For the foregoing reasons, the Petition for a Writ of Certiorari should be granted.

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